



Unification of Rates – Informational Item

Information Only

One of the statutory authorities of the Technology Service Board (TSB) is the review and approval of the Department of Technology Services' (DTS) rate packages. This agenda item is to provide TSB with an overview of DTS rates. The TSB will be asked at future board meetings to take some action on DTS rate packages.

Introduction

The Department of Technology Services (DTS) provides a variety of information technology (IT) services to numerous state and local agencies which pay DTS for its operational costs. These revenues are provided through fees or “rates” that are based on the cost of providing each of the services. Revenue collected from customer billings are deposited in the DTS Revolving Fund, from which the entire DTS budget is appropriated.

This document is intended to provide the Technology Services Board (TSB) with an overview and understanding of:

- How DTS calculates rates,
- The problems that DTS experiences with its rates,
- How DTS proposes to resolve these problems, and
- The actions that the TSB will be asked to take over the next 18 months on future rate packages.

Background

Rates are the basis by which DTS recovers its operational costs. There are several components, as discussed below, which are involved in DTS rate calculations.

Rates Vary Depending on the Characteristics of the Service Provided. There are three primary methodologies that DTS uses for charging rates:

- ***Measured Usage:*** Customers are charged based on their usage of the service. Typically, these types of rates consist of a unit of utilization. This model is used primarily for services in which significant sharing of resources occurs, such as mainframe processing and storage.
- ***Subscription:*** Customers are charged a flat rate for the service, regardless of actual utilization. This model is used primarily for services in which there is very little sharing of resources. For example, mid-range computer services are subscription services.



Customers pay a flat rate each month for a mid-range computer server, and there is no fluctuation due to utilization in pricing.

- ***Direct Charge:*** Customers are charged the actual cost of the service or product, plus an administrative fee. This model is used primarily in cases where a customer's requirements are unique and, therefore, it is not appropriate to include the related costs in the calculation of rates that would be charged to other customers. It is also used for services that are driven primarily by contracts. For example, DTS print and microfiche services are provided by a contractor.

Rate = Total Cost of Service / Estimated Volume of Billable Units. Rates are intended to represent the per-unit cost of the service provided. For this reason, a rate is basically the cost of the service divided by the number of units the DTS estimates it will provide to customers.

“Total Cost of Service” Includes All Direct Costs as Well as A Share of Indirect Costs. Most DTS rates also include a share of indirect costs, which are those costs that DTS incurs to support the service and department operations. Figure 1 provides examples of direct and indirect costs that are ultimately recovered by a billing rate.

Figure 1
Direct and Indirect Cost Examples

Cost Category	Examples
Direct	Purchase price of hardware and software
Indirect	Operation of help desk Installation of software upgrade Operation of system security Assistance to customers Facilities lease and utility costs Share of DTS administrative costs

Cost Accounting is Essential to the Development of Rates. To determine the cost of providing services, DTS maintains a cost accounting function. This function captures all DTS costs and then distributes those costs to the appropriate service. In addition, the cost accounting function spreads the one-time purchase costs over the useful life of the product. For example, a mainframe computer may cost several millions of dollars. This cost, however, is amortized over the expected useful life of the mainframe in order to appropriately recover the cost from DTS customers.

Revenue/Expense Analysis Measures Accuracy of Rates. By comparing the cost of services to the revenue collected through the respective rates, DTS is able to monitor the financial performance of its various services and make adjustments to rates as necessary to keep revenue aligned with costs. For most established services, this revenue to expense analysis is the most effective way of estimating the need and magnitude of rate adjustments. However, developing rates for new services usually requires that the rate be established by estimating each of the



individual cost components such as those listed above. For subsequent years, DTS monitors the service and makes the necessary changes to “adjust and align the rate.”

There Are Many Benefits of A DTS Rate Structure Aligned With Costs. Figure 2 lists the benefits that a good DTS rate structure provides for its customers and the statewide management of IT resources. Many of these benefits, however, are dependent upon rates being well aligned with the underlying cost of each service.

Figure 2
Benefits of A Well Aligned Rate Structure

Recipient	Benefit Received
Customer agency	<ul style="list-style-type: none">• Meets federal funding requirements.• Distributes DTS costs on a fair, equitable, and consistent basis.• Reduces fluctuations in IT costs because one-time costs are built into monthly charges.• Assists in making business decisions by providing a basis to estimate the cost of using DTS services.• Influences purchasing decisions by providing cost effective solutions to business problems.
DTS	<ul style="list-style-type: none">• Recovers costs for providing service.• Provides metric for the performance of DTS services.• Allows for a comprehensive support of services.• Streamlines funding process through an internal service fund.

DTS Has Many Challenges with Its Rates

In June 2005, the former Stephen P. Teale Data Center (TDC) and the Health and Human Services Agency Data Center (HHSDC) contracted for consulting services to (1) assess the data centers’ rate structures, (2) identify problems with those rate structures, and (3) make recommendations on how to resolve those problems and move to a DTS single rate schedule. Appendix A provides the executive summary of that assessment. The following provides a high-level description of the problems that the assessment identified:

Data Centers Were Not Allowed to Increase Rates for Some Services When Necessary. State policy provided the Department of Finance (DOF) authority to review and approve TDC rates. Similarly, HHSDC’s Policy Advisory Council, made up of customers, had the authority to review and approve its rates. In both cases, impact to customer budgets was the primary concern of rate setting. If rates needed to increase and those changes would result in an aggregate increase to individual customer bills, those changes were typically not approved.

Data Centers Over-collected on Mainframe Rates and Under-collected on Non-mainframe Rates. Over time, data center mainframe costs have significantly decreased. Since TDC and HHSDC were not allowed to increase rates for some services, the two departments maintained their mainframe rates at a higher than break-even level in order to cover the expenses of the other services that were not fully recovering their costs. For example, in 2004/05, TDC and HHSDC



over-collected \$33.7 million in mainframe services, and under-collected \$13.2 million in mid-range computer and network services. In addition, federal regulations prohibit subsidization of data center services that use federal funds. The DTS houses many federally funded systems.

Data Centers Used Different Service Models. Both TDC and HHSDC offered their customers similar services. The services, however, included different components, which resulted in different costs between the two data centers. For example, TDC mid-range computer services were based on the size of the computer—small, medium, or large, plus incremental size increases. The HHSDC, on the other hand, charged a base rate, plus additional charges, depending on the size of the computer’s memory and internal processors. In addition, variations in hardware, software, maintenance, storage, and support account for differences in the data center rates. As a result, customers paid very different data center rates for similar services.

Data Centers Had Many Different Rates That Were Complex and Difficult to Understand. Prior to consolidation, TDC and HHSDC maintained their own rate schedules. Upon consolidation, these two rate schedules were merged. The DTS has approximately 200 separate rates for its services. Some rates appear to be duplicates but, may not be, due to differences in service models or utilization metrics used by each campus. For example, the current DTS rate schedule includes 16 different line items for forms, 72 different line items for networks, and 52 different line items for non-mainframe systems. It is not clear how many of these line items are unique or could be consolidated into common rates. In addition to having many different rates, it is not clear what *is* included in the different rates because the data centers did not provide details about service offerings. For example, it is not clear what level of support, maintenance, and security is included in non-mainframe services. This difference in rates makes it difficult for customers to compare costs between DTS and other entities when making decisions about where to locate hardware and software.

DTS Will Adopt Strategies to Solve These Problems

We agree with the assessment’s recommendations for resolving the problems identified above. (Appendix B provides our implementation schedule to address the assessment’s recommendations.) In addition, we will adopt five strategies, discussed below, in resolving our current rate problems and to prevent these problems in the future.

Adopt A Policy That Rates Should Match Costs. The assessment provided a number of guiding principles that we could adopt in establishing our rates. (See Agenda Item 5E for the action item related to these guiding principles.) In our view, these guiding principles provide a framework for establishing policies and procedures for cost allocation, cost accounting, and rate development. In addition, the guiding principles can be used to help lead us towards consistency and uniformity in our rate policies and procedures. The primary theme in the assessment’s guiding principles is that rates should match the cost of providing the service. This theme is consistent with federal law and state policy. For this reason, we will adopt a policy that our rates should match the costs to provide the service levels required by our customers.



Implement Common Service Models. The assessment found that TDC and HHSDC had similar methodologies for developing rates. The rate structures, however, were based on providing different components for the same service. For example, HHSDC's network services included a cost component to periodically replace telecommunication equipment whereas TDC's network service did not include this cost component. In order to remedy this situation and to support the realignment of rates, we will develop a common service definition for each of our services.

Develop Simplified Rate Structures. The merging of TDC's and HHSDC's rates has created a highly complex and lengthy schedule of rates. To remedy this, we will adopt the assessment's recommendation to streamline rates by identifying and eliminating redundant rates. In addition, we plan to consolidate similar cost centers and rates, thereby simplifying our rate structures.

Realign Rates. A key objective of rate setting is to establish rates that will recoup all of the costs incurred for the specified levels of service. The assessment pointed out that some of our services do not fully capture the cost of providing the service. To comply with federal law, state policy, and the guiding principles, we will realign our rates over time for some services in order to match revenues with expenses.

Determine How Rate Changes Will Affect Customer Budgets. As common service models are developed, we will identify projected rate adjustments and how those rate changes will impact our customer budgets. We will also identify how those rate changes can be used to correct some of our under-collection problems. For example, we know that our mainframe services have historically generated more revenues than expenses. When we analyze possible mainframe rate reductions, we will also examine how those rate reductions can be used to offset each customer's increased costs for those under-collecting services for which rates need to be adjusted upward. As we review each customer's use of our services, we will identify the total cost impact of rate adjustments and realignments on each customer.

DTS Will Implement These Strategies Through Future Rate Packages

To implement our rate strategies, we will make changes in our rates in our next three rate packages, as discussed below.

2006/07 Rate Package Will Make Some Improvements. We will provide our 2006/07 rate package to DOF on April 28, 2006. Upon completion of DOF's review, the rate package will be presented to the TSB on June 28, 2006. At this point, we do not expect our 2006/07 rate package to include rate realignments that would require customer budget augmentations.

Currently, we believe our 2006/07 rate package will:

- Implement some of the assessment's recommendations.



- Merge some rates into other rates in order to be more meaningful to our customers.
- Provide a lower rate for similar services with the same cost.
- Eliminate unused rates.
- Reduce some rates that have been over-collecting.
- Increase some rates for obsolete or out-dated services.
- Increase some rates based on new contract agreements with outside vendors.

2006/07 Mid-Year Rate Package Will Implement Some Rate Realignments. Over the next few months, we will develop common service models for some of our services. In addition, we will reexamine some of our services to determine if additional rate reductions can be achieved. These activities will allow us to make some rate realignments in 2006/07. For this reason, we will provide a mid-year rate package to the TSB sometime in 2006/07.

2007/08 Rate Package Will Continue Improvements. After our mid-year rate package, we will also provide our 2007/08 rate package to DOF and TSB. We expect this rate package to be provided to the TSB towards the end of 2006/07.

Currently, we believe our 2007/08 rate package will:

- Implement the remaining assessment recommendations.
- Complete the implementation of common service models
- Simplify and clarify rate structures.
- Decrease overhead rate by moving some direct costs to other rates.

Conclusion

By conducting a number of activities over the next 18 months, we expect to remedy the past problems with data center rates. In addition, we will implement common service models that our customers will find valuable in support of their programs. Finally, by realigning rates through a series of rate packages, we will have a solid and consistent rate structure that minimizes impacts to our customers' budgets and provides good information about the true costs of providing shared services.



Agenda Item 5D
Appendix A
Rate Assessment Executive Summary

EXECUTIVE SUMMARY

BACKGROUND, SCOPE AND OBJECTIVES OF THE REVIEW

The Department of Technology Services (department) contracted with MGT of America, Inc. (MGT) to conduct a formal rate methodology review to address the strategy and requirements for governing data center cost recovery, as set forth in state laws and regulations. The department was established in July 2005, as a result of the California Data Center Consolidation Project—a 30-year old vision to bring the state’s large-scale computing centers together into a single entity. The goals of this project were to reduce data center operating costs, deliver “best practice” technology services more effectively, and improve the operations, reliability, and security of the state’s information technology (IT) solutions.

The Governor’s Reorganization Plan provided the legal authority for the establishment of the department under the jurisdiction of the State and Consumer Services Agency and covers the integration of the Health and Human Services Agency Data Center (HHSDC), Stephen P. Teale Data Center (Teale) and the Department of General Services’ Office of Network Services (ONS). The department was established to serve as the primary IT provider in the state. Its mission is to serve the common technology needs of executive branch agencies and other public entities with accountability to customers for providing secure services that are responsive to their needs and represent the best value to the state.

The Governor’s Reorganization Plan also established the Technology Services Board (TSB) to provide governance and guidance to the department and to ensure appropriate oversight and customer orientation. The TSB is responsible for overseeing and approving the department’s budget and rate methodology.

One of the department’s objectives during the consolidation of the data centers is to develop a common set of methodologies for identifying the costs of data center services and recovering those costs through user charges. Teale and HHSDC—now referred to as the Gold Camp campus (Gold Camp) and the Cannery campus (Cannery) respectively—each utilized a different set of cost recovery and rate setting procedures. As part of the rate methodology review, the department requested MGT to address the impact of the newly consolidated environment on the cost recovery and rate setting of IT services and specified the following elements to be included in the scope:

- Document the current rate-setting processes for the data centers.
- Describe the differences and shortfalls between the data centers.
- Identify “best practice” proposals that are in current use by other governmental agencies that use generally accepted accounting principles

and U.S. Office of Management and Budget (OMB) Circular A-87 requirements.

- Propose options that may “best fit” the consolidated organization model for the IT provider solution for all state departments.
- Propose methodologies for setting fair, reasonable, and justifiable rates.

Our review of the department’s rate methodology focused on the methodology’s three major components—cost allocation, cost accounting, and rate development—pertaining to the data center operations at Gold Camp and the Cannery.¹ Each component represents an important element in the department’s efforts to recover the costs of services it provides.

- **Cost Allocation:** The methodology and structure for identifying costs of services provided and how costs will be recouped from those customers receiving the services. Cost allocation includes the identification of direct and indirect costs and the allocation of indirect costs to specific services.
- **Cost Accounting:** The methodology and structure for identifying and recording costs incurred to provide services, such as hardware, software, personnel, and operating expenses.
- **Rate Development:** The methodology and structure for determining the amounts to charge customers for services. Rate development includes the determination of appropriate rate methodologies based on the nature of the services provided and forecasts of costs and utilization.

ISSUES IMPACTING THE RATE METHODOLOGY

The consolidation of the data centers is an enormous project with ramifications on agencies and departments throughout the state. Because of this impact, there has been significant emphasis placed on the planning and coordination of operations, as evidenced by the formation of the TSB and the department’s Consolidation Management Office. These planning and coordination efforts include addressing any consolidation-related issues, including those that impact the rate methodology, as early as possible. The department will need to address the following issues, each of which has a direct impact on the methodologies used to develop rates and recover costs.

EVOLUTION OF IT SERVICE DELIVERY IN THE STATE

One of the considerations that the department will need to take into account in developing a consolidated rate methodology is the evolution of IT service delivery in the state. Based on recent publications addressing IT governance, the state’s IT leaders believe that the state needs to shift its focus

¹ The ONS was not included in the scope of the review because it does not provide data center services to state departments.

towards developing technology solutions that benefit the statewide enterprise, as opposed to individual agencies. The Statewide IT Strategic Plan calls attention to this change, as reflected in the following excerpt:

“Many of our service delivery systems are outdated and inconvenient, internal business systems are antiquated and fragmented, and statewide planning for technology is ineffective. Our technology programs operate with an agency focus and for the convenience of government rather than with an enterprise focus and for the convenience of citizens, resulting in duplication, waste, and inconsistent results.”²

The Statewide IT Strategic Plan outlines an agenda for redefining the management of IT resources to improve service delivery and streamline internal operations. In particular, the plan states a desire to align technology to an enterprise perspective and to focus investments on initiatives that will enable significant improvement in statewide service delivery and business operations.

The method of service delivery will impact the definition of what is included in the service offering, which will consequently impact the costs that are included in the rate. As the department consolidates its services and identifies those services that need to be modified in order to align with the change in service delivery, it will need to analyze those costs that should be included in the updated service. The rate methodology may also be affected if the change in service delivery results in a change in the chargeback model.

CONFLICTING BUSINESS MODELS

Before proceeding with the development of a consolidated rate methodology, the department will need to decide on the business model under which the new organization will operate. Prior to the consolidation, Teale and HHSDC functioned under significantly different business models.

Prior to the consolidation, Teale was the largest data center in the state. State policy stipulated that Teale was responsible for serving those state departments that were not already assigned to a specific data center. Although Teale resided within the Business, Transportation, and Housing Agency, its customers included departments from all areas of government. The size of the data center, broad range of services provided, and variety of customers resulted in Teale’s business model resembling that of an external service provider. Although some of Teale’s operational and business objectives may have been similar to those of its customers, it generally operated as an independent service entity.

On the other hand, HHSDC operated under a significantly different business model. It was organized under the Health and Human Services Agency

² California State Information Technology Strategic Plan—Update to the 2004 Plan, November 2005.

and was created in order to serve as the exclusive data center for departments within this agency. Under this model, HHSDC was considered the IT branch of the state's health and human services operations, similar to a technology division within a large corporation. This structure empowered HHSDC to provide full-scale services to meet the common needs of its customers. For instance, HHSDC's service of providing network access not only involved supplying the necessary hardware and circuits for the connections, but also included purchasing new equipment on behalf of all customers as technology upgrades became available. This equipment "refresh" was a core objective in ensuring efficiency throughout the health and human services operations.

In contrast, Teale did not provide equipment as part of its network services, leaving that responsibility to its customers. Because Teale had over 250 customers with different requirements for service levels, it purchased new equipment only at the request of a customer and passed the related costs directly to that entity.

Although the former data centers share some similarities in their approaches, the notable differences in the business models result in inherent conflicts when attempting to develop a consolidated rate methodology. Developing a common rate structure for a service provided at both data centers may result in inequitable cost recoveries due to the data centers providing different levels or forms of service.

INABILITY TO CHARGE RATES BASED ON FULL COSTS

Despite the use of structured rate methodologies, the campuses are constrained in their ability to set fair and reasonable rates because of directives from the entities responsible for reviewing and approving the rates. Prior to the consolidation, Gold Camp was responsible for developing its proposed rate schedule and submitting these rates to the Department of Finance (Finance). The annual budget act gave Finance the authority to review and approve the rates. A primary objective of Finance's review was to ensure that rates did not adversely affect customers' budgets, meaning that any changes in the data center's rates could not result in an aggregate increase in customers' bills.

One example of the impact of Finance's directive on Gold Camp's ability to set appropriate rates was the rate development process for fiscal year 2003-04. Similar to previous years, Gold Camp developed a new proposed rate schedule for fiscal year 2003-04 to include new rates for all of its services, including mainframes, servers, and network services. However, staff indicated that because of concerns raised by Finance regarding the impact of these proposed rates on customer budgets, Gold Camp ultimately withdrew its proposal and continued to use the same rate schedule from fiscal year 2002-03 to charge for its services. Because the cost per unit for servers and network services continued to increase at the same time that mainframe per-unit costs decreased, using the same rates from the previous year meant that Gold Camp

was overcollecting revenue for mainframe services and undercollecting revenue for servers and network services. In essence, by paying higher rates for mainframe services, these users were subsidizing the costs of the server and network users.

Unlike Gold Camp, the Cannery was not required to submit its proposed rates to Finance for approval. Prior to the consolidation, the Cannery provided a rate package to the Policy Advisory Council (PAC) each year. The PAC, comprised of various customers, had the authority to review and approve the Cannery's rates, but did not have an official objective similar to Finance's directive. Nevertheless, the Cannery was also cognizant about the impact of its rates on customers' budgets. Despite employing advanced techniques for forecasting costs and utilization of mainframe services, it still established mainframe rates that were somewhat higher than the costs required to support the systems.

The current practice of cross-subsidizing services is in direct conflict with federal requirements and the department's *guiding principles* for cost allocation and rate setting. One of the *guiding principles* states that "One project, product, process or activity should not support or subsidize another." However, the constraints placed on the campuses in the past, along with the impact of rate increases on customers' budgets, have contributed to an environment in which the campuses have not always adjusted their rates to accurately reflect the costs of the services. As a result, excess revenues generated from mainframe services are subsidizing the costs required to provide servers, network services, and other categories of service. A comparison of revenues and expenses for mainframe services shows that revenues exceeded expenses by \$6.1 million for Gold Camp and \$27.6 million for the Cannery during 2004-05.³

RECOMMENDATIONS

The following pages identify recommendations for the department to consider in its efforts to consolidate its rate methodologies. The recommendations are organized by central themes. In Chapter 6.0, we present the recommendations at a detailed level and provide our suggestions for prioritization and implementation.

THEME #1:

ADOPT THE GUIDING PRINCIPLES

In order to provide a consistent and agreed-upon set of guidelines and principles, the TSB should formally adopt the proposed *guiding principles* for cost allocation and rate setting methodologies developed as part of this review. The principles provide high-level guidance for the department as it evaluates

³ According to staff at the Cannery, the excess revenues of \$27.6 million were subsequently returned to customers.

alternatives and identifies criteria against which specific policies and procedures will be reviewed and modified. In particular, the *guiding principles* can be used to help guide the newly consolidated organization in its efforts to establish consistency and uniformity among its policies and procedures. Once adopted, the principles should be communicated to all department staff and should be shared with key stakeholders, including customers, state control agencies, and the federal government. Furthermore, the department and the TSB should periodically revisit these principles and modify them as conditions warrant.

THEME #2:

ADOPT A UNIFORM BUSINESS MODEL THROUGHOUT THE ORGANIZATION

As a newly consolidated entity providing IT resources throughout the state, the department will need to adopt a formal business model and implement its usage throughout the organization. The model should consider the vision addressed in the Data Center Consolidation Project as well as other perspectives relevant to the consolidation efforts, such as the Statewide IT Strategic Plan. The department should also seek guidance from the TSB regarding the choice of business model.

THEME #3:

DEVELOP AND IMPLEMENT A UNIFORM COST ALLOCATION METHODOLOGY

Gold Camp and the Cannery have been using different methodologies for identifying and assigning personnel and operating costs to individual service offerings, which has resulted in inconsistent allocations of certain costs. As a single consolidated entity, the department should establish a uniform cost allocation methodology to be adopted throughout the organization. Examples of specific recommendations that address this topic include the following:

- Develop a consolidated set of cost centers to encompass all services provided by the campuses.
- Review the reasonableness of existing drivers and allocation percentages used for distributing indirect costs and update assumptions and estimates accordingly.
- Distribute indirect expenses of the organization to cost centers on a monthly basis in order to provide staff with timely information on the financial status of service offerings.
- Implement a standard process to review overhead and other indirect cost distributions.
- Develop an organization-wide system to collect after-the-fact distributions of actual staff activity for use in cost recovery.

THEME #4:

PROACTIVELY MANAGE COST CENTERS

Establishing cost centers within the financial system provides a tool that organizations can use to assist in their cost allocation efforts. Cost centers provide an organization with the ability to account for revenues and expenses at the service offering level, to assess whether costs are being allocated properly, and to determine whether rates are set at the appropriate levels for full cost recovery. Although both campuses have been using cost centers to track revenues and expenses, neither one utilizes cost center managers to actively monitor their activity on a regular basis. Examples of specific recommendations that address this topic include the following:

- Designate specific individuals within the department to serve as cost center managers.
- Develop and document specific responsibilities for cost center managers to adhere to throughout the organization. It is critical for all cost center managers to adopt a consistent level of responsibility for managing costs of their services, and the department should identify its basic expectations for these responsibilities.
- Establish formal assignments of cost center managers to ensure that individuals at appropriate levels within the organization are responsible for monitoring revenues and expenses associated with their services.
- Establish formal procedures for cost center management to ensure that cost center managers are monitoring costs consistently and are using the same criteria for determining whether revenues are in line with costs.
- Conduct periodic cost center manager meetings to coordinate efforts among the managers over their responsibilities.

THEME #5:

IMPLEMENT INTEGRATED FINANCIAL SYSTEMS FOR COST ACCOUNTING

The ability to collect accurate and reliable financial information is a critical requirement in the department's effort to recover costs. The department needs to focus its attention on moving from its current financial reporting structure of multiple stand-alone systems to a comprehensive integrated financial system. The lack of integration among many of its current systems has resulted in inefficiencies in the department's cost recovery efforts. Examples of specific recommendations that address this topic include the following:

- Implement a consolidated departmental cost accounting system for use throughout the organization to accumulate, allocate, and track revenues and expenses by service offerings. Ensure that the system is able to

interface with other sources as needed in order to obtain applicable data used to identify costs, such as hardware, software, and personnel.

- Consolidate the billing systems of Gold Camp and the Cannery into a single department-wide billing system.
- Develop a department-wide cost center financial reporting system to track revenues and expenses of cost centers throughout the organization. Consider merging this system with the cost accounting system.
- Identify other opportunities to consolidate or merge systems that contain redundant data or that serve duplicative purposes.
- Train staff on the applications and usage of the consolidated financial systems to ensure that the department is efficiently maximizing the capabilities of the integrated systems.

THEME #6:

DEVELOP RATES THAT WILL FULLY RECOVER COSTS

The department has expressed its desire to establish fair, reasonable, and justifiable rates that will cover the costs of services provided and will allow its operations to break even. As discussed in Chapter 1.0, one of the department's *guiding principles* states that the revenues generated from the rates should fully recover the costs of the service, plus allowable reserves for working capital and equipment replacement. Examples of specific recommendations that address this topic include the following:

- Use the standard rate-setting formula described in Chapter 4.0 to develop rates for services across the consolidated organization.
- Develop estimates for costs and utilization incurred during the period in which the rate will be applicable. The costs of a service should include all costs that can be directly attributable to providing the service, such as personnel, operating, hardware, and software expenses. In addition, all indirect costs, including an appropriate allocation of overhead, should be included in the costs of the service. Utilization should account for the anticipated demand for the specific service during the period.
- Develop statistical-based projections to assist in preparing cost and utilization estimates.
- Identify services with significant variances in revenues and expenses and revise the rates for those services to align with the costs incurred.
- Periodically review rate structures and rate-setting methodologies for the various services and modify approaches, as needed.

THEME #7:**ADDRESS THE IMPACT OF CUSTOMER BUDGETS ON RATES**

Although Finance's directive was intended to maintain stability of IT costs in customers' budgets, it has resulted in widespread inequities throughout the customer community. The federal government also expressed concerns about the ability of internal service-funded entities, such as the department, to charge their federally funded customers appropriate rates for the services being provided. Circular A-87 establishes specific requirements governing the allowability of expenses to be paid from federal funds. Specifically, the circular prohibits charging federally funded programs using rates that are not based on the costs incurred to provide the services. Entities whose rates are not reflective of costs run the risk of jeopardizing the state's ability to seek federal reimbursements.

The department should meet with the TSB and Finance to develop a common understanding of the rate development process and to seek agreement on the objectives of full cost recovery on a service-by-service basis. The department can use the *guiding principles* and Circular A-87 as criteria to help provide context in the discussion.

In an initial discussion with Finance representatives regarding this issue, they agreed with the provisions of Circular A-87 and the concept that rates for services should be commensurate with the costs incurred to provide those services. They also stated that the department's responsibility is to develop its rates based on projected costs and utilization, independent of the impact on customers' budgets. Furthermore, they were willing to work with the department to ensure that rates are in line with costs.

The budget representatives recommend improving communication regarding customer usage as a means to help address the impact of the budget on the rate development process. In particular, they believe that it is important for customers to clearly communicate their expected technology needs in a manner that would help both the department to adjust its rates and Finance to review and authorize funding. The budget representatives suggested working with the TSB to request customers to provide this information.

It is important to note the critical nature of this recommendation and the significance of its implementation. Almost all of the other recommendations in our report are based on the department's ability to recover the full costs incurred to provide its services. If the state is unable to resolve this issue, all of the department efforts to allocate costs and develop rates based on detailed methodologies will serve no purpose. Furthermore, not only does the budget restriction result in the department continuing to charge customers inequitably, but it also jeopardizes the ability of otherwise-eligible customers to seek federal reimbursements.



Agenda Item 5D
Appendix B
Implementation Schedule for Assessment's Recommendation



Appendix B

Implementation Schedule for Assessment's Recommendations

The rate methodology review of DTS concluded that the department has made progress in developing a cost recovery structure for the newly consolidated organization, but many areas still need to be addressed. As a result, DTS will adopt the recommendations by fiscal year as noted below:

Fiscal Year 2005/06

- Present the Guiding Principles for cost allocation and rate setting to the TSB for formal adoption. (Chapter 1)
- Establish a process to periodically review the Guiding Principles and modify them as conditions warrant. (Chapter 1)
- Implement a standard process to review overhead and other indirect cost distributions on an annual basis and continue to explore the use of alternate cost drivers. (Chapter 2)
- Distribute indirect expenses of the organization to cost centers on a monthly basis. (Chapter 2)
- Develop a consolidated set of cost centers to encompass all services provided by the campuses. (Chapter 2)
- Develop statistical-based projections to assist in preparing cost and utilization estimates. (Chapter 4)

Fiscal Year 2006/07

- In conjunction with the TSB, adopt a formal business model for service delivery and cost recovery. (Chapter 1)
- Perform a detailed analysis of overhead costs to identify those types of costs that can be extracted from the overhead pool and distributed to selected cost centers using a more applicable cost driver. (Chapter 2)



- Designate specific individuals within the department to serve as cost center managers. (Chapter 2)
- Develop and document specific responsibilities for cost center managers to adhere to throughout the organization. (Chapter 2)
- Establish formal assignments of cost center managers to ensure that individuals at appropriate levels within the organization are responsible for monitoring revenues and expenses associated with their services. (Chapter 2)
- Conduct periodic cost center manager meetings to coordinate efforts among the managers over their responsibilities. (Chapter 2)
- Adopt a centralized organizational structure for financial management operations as a framework for establishing control and consistency in the consolidated environment. (Chapter 3)
- Use the standard rate-setting formula to develop rates for services across the consolidated organization. (Chapter 4).
- Adopt a centralized rate-development function involving a single group who will have overall responsibility for implementing uniform standards for cost recovery and rate setting. (Chapter 4)
- Develop a uniform approach for monitoring revenues and expenses of cost centers and services. (Chapter 4)
- Communicate with the TSB and Finance to develop a common understanding of the rate development process and to seek agreement on the objectives of full cost recovery on a service-by-service basis. (Chapter 4)
- Establish criteria for the level of documentation required to support the rate calculations. (Chapter 4)
- Adopt Gold Camp's rate structure for recovering the costs of servers. (Chapter 4)
- Discontinue the service of providing database licenses to customers and request that users obtain the licenses directly from the vendors. (Chapter 4)
- Implement an interim consolidated cost accounting system for use throughout the organization to accumulate, allocate, and track revenues and expenses by service offerings. (Chapter 2)



- Identify other opportunities to consolidate or merge systems that contain redundant data or that serve duplicative purposes. (Chapter 3)

Fiscal Year 2007/08

- Review the reasonableness of existing drivers and allocation percentages used for distributing other indirect costs. (Chapter 2)
- Document its methodology for recovering costs of services provided, including the allocation of indirect costs. (Chapter 2)
- Establish formal procedures for cost center management to ensure that cost center managers are monitoring costs consistently and are using the same criteria for determining whether revenues are in line with costs. (Chapter 2)
- Train staff on the applications and usage of the consolidated financial systems to ensure that the department is efficiently maximizing the capabilities of integrated systems. (Chapter 3)
- Develop formal policies and procedures for identifying and assigning costs of services and training staff on their criteria. (Chapter 3)
- Develop a single, consolidated set of service offerings for use throughout the department. (Chapter 4)
- Identify services with significant variances in revenues and expenses and revise the rates for those services to align with the costs incurred. (Chapter 4)
- Periodically review rate structures and rate-setting methodologies for the various services and modify approaches, as needed. (Chapter 4)
- Establish a uniform business model across the organization in order to provide an agreed-upon basis for consolidating network services. (Chapter 4)

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- Develop an organization-wide system to collect after-the-fact distributions of actual staff activity for use in cost recovery. (Chapter 2)
- Develop a department-wide cost center financial reporting system to track revenues and expenses of cost centers throughout the organization. (Chapter 3)



- Ensure that the new cost accounting system has the capability to allocate indirect costs to an unlimited number of cost centers. (Chapter 2)
- Implement a consolidated departmental cost accounting system for use throughout the organization to accumulate, allocate and track revenues and expenses by service offerings. (Chapter 3)
- Monitor the implementation of PeopleSoft throughout the department to identify opportunities to integrate cost accounting applications and other systems within the PeopleSoft environment. (Chapter 3)
- Analyze the capabilities of PeopleSoft and Remedy and identify an appropriate asset management system for the consolidated department. (Chapter 3)
- Consolidate the billing systems of Gold Camp and Cannery into a single department-wide billing system. (Chapter 3)